Canada. Office of the Auditor General.
Accountability, accounting and audit.

(Discussion paper no. 48)

Office of the
Auditor General
of Canada

Bureau du
vérificateur général
du Canada

DISCUSSION PAPER No. 48

ACCOUNTABILITY, ACCOUNTING AND AUDI

by E. F. McNamara

:il 1985

DISCUSSION PAPER SERIES
DOCUMENTS DE DISCUSSION

attached paper has been prepared to stimulate ıght and discussion regarding our audit vities. The views expressed are those of the ıor and therefore should not be construed as se of the Office.

r comments would be appreciated and should be cted to the attention of the author.

litional copies of this paper, or other papers in "Discussion Paper Series", may be obtained ugh the PROFESSIONAL PRACTICES GROUP.

Le document ci-joint vise à stimuler la réflexion et la discussion sur nos activités de vérification. Les opinions exprimées dans ce texte sont celles de l'auteur et, par conséquent, ne lient pas le Bureau.

Vos commentaires seraient appréciés et vous êtes priés de les faire parvenir à l'auteur.

Vous pouvez vous procurer des exemplaires supplémentaires de ce document ou des autres écrits de la série des "Documents de discussion" en vous adressant à la DIRECTION DES MÉTHODES PROFESSIONNELLES.

DISCUSSION PAPER No. 48

ACCOUNTABILITY, ACCOUNTING AND AUDIT

by E. F. McNamara

April 1985

Purpose of this Paper

This paper sets forth the position that comprehensive auditing should be performance based. It should examine the performance elements for which a department is accountable to Parliament, how it accounts for them and how it manages them. Accountability, accounting and audit must be tied closely together so that the value for money of the Office's product is recognized and appreciated by Parliament.

Accountability and Matters of Significance

Definitions of Accountability, Accounting and Audit

The Wilson Committee Report on the role of the Office of the Auditor General, published in 1975, launched the Office on its way toward value-for-money auditing. The Report contains three interesting definitions of accountability, accounting and audit which are relevant to considerations of matters of significance:

1. Accountability in its simplest terms means the obligation to answer for a responsibility that has been conferred. It presumes the existence of at least two parties: one that allocates responsibility and one who accepts it with the undertaking to report upon the manner in which it has been discharged.

2. To avoid misunderstanding or misinterpretation of the information provided, clear standards or conventions relating to the appropriate form of disclosure should be established and agreed upon by both parties. If this can be done, accountability can be maintained even in the most complex situations.

3. Audit is a process that is superimposed on an accountability relationship. It is carried out to establish that a report on the responsibility assumed is a correct or a fair one and is usually performed by a third party, primarily serving the interests of the party who delegated the responsibility.

These definitions apply in both the private and public sector. In the private sector, shareholders, through a board of directors, delegate certain responsibilities to corporation management. They then require an accounting from management on how this responsibility has been carried out. That accounting is then audited by a firm of public accountants who advise the shareholders on the fairness of the information provided. Where, in the opinion of the auditors, such information is not fair or is somehow lacking in substance, they may withhold their opinion, qualify it in some way or even provide to the shareholder the missing data that should otherwise have been disclosed. It is the various corporations' acts and CICA pronouncements that determine levels of disclosure. Looked at from the Wilson Committee's point of view, the requirements for accountability, accounting and audit are usually met in the private sector. There is some doubt that they have been met in the public sector, certainly not at the federal level.

The accountability of the Government to Parliament has never been defined precisely. That is to say, there is no list of accountability issues to which one can refer to understand the nature of the Government's accountability. However, the fact that the Auditor General Act requires certain matters to be audited suggests that Parliament wishes to hold the Government accountable in those areas. It does not mean there are not other areas of accountability between the Government and Parliament, but rather that the OAG should concern itself primarily, if not exclusively, with those matters set out in the AG Act - those "matters of significance."

Using the AG Act as a reference point, the Government's accountability to Parliament should include matters of financial regularity, legislative compliance and economy, efficiency and effectiveness. These matters of significance are

discussed here in the context of how the Government should account for them and how the OAG should audit them.

Accounting for Accountability

The Office examines the Government's financial statements in much the same manner as a public accounting firm would those of a corporation. By doing so, we seem to imply that the government's financial statements address the accountability of the Government to Parliament as fully as a corporation's financial statements do its accountability to shareholders. That is not the case.

In the private sector, financial statements permit the performance of corporations to be assessed in terms of net profit or loss and return on investment. Furthermore, it is clear to everyone that these are the primary objectives. In the public sector, the financial statements simply indicate sources of funds and the broad areas in which funds have been spent. Little can be inferred about performance from the government's financial statements. While the Office spends a great deal of money, time and talent in expressing an opinion on the government's overall financial statements, it is not clear what aspect of the government's performance we are addressing.

To quote the Wilson Committee again:

> Today, in most of the larger democratic countries, the legislature grants money to the administration, not only with the restriction that it be spent only for the purposes specified, but also subject to the assumption that it will be spent in a prudent manner or, as the British would say, that "value-for-money" will be obtained.

The government's present accounting does not address adequately the question of disclosing the extent to which value for money has been obtained. In the private sector this is tantamount to not showing the sales figure or some equally important performance-related information. Nevertheless, in the past not only have we spent a great deal of energy attesting to the financial information

provided, but we have often gone further and suggested ways that much of this information could be made more precise, but hardly more useful.

The House of Commons should be adequately informed on the government's performance. Are government programs effective? Are they operated at least cost? Are there wasteful expenditures? MPs should have information that permits them to judge whether the government has obtained value-for-money for its expenditures. The Office should ensure that the House of Commons gets reliable performance information. Value-for-money is at the heart of the accountability issue; therefore, we should make certain that Parliament is informed of the value for money obtained through government expenditures.

It is the Government's responsibility to inform the House of Commons about its performance. Part III of the Estimates provides tremendous potential for government departments to account for achieving value for money. In Part III of the Estimates, departments are required to include effectiveness and performance information "to enhance government's accountability to Parliament." The information should be performance-based and compiled so that it gives a fair representation of performance. The Office can influence how quickly this comes about by focusing our efforts more directly on this "performance accounting" - attesting to the key performance information and calling attention to any serious information shortcomings.

In a Research Paper, "A Political Guide To The Estimates", members of a federal caucus were advised of some general points to consider when reviewing an Expenditure Plan ...

(1) Objectives - Are they measureable? Is the program having its desired effect? Is the desired effect desirable? Does the department use meaningless words such as "to provide adequate service" or "to improve"?

(2) Effectiveness - Are the measures for evaluating effectiveness meaningful? If graphs are used, are they showing information in

an honest way, or do they use exaggerated scales? Are you given meaningful information, or have you merely been told that the sky is blue on a sunny day? What information is not shown?

(3) New Initiatives -What is the time frame of the new initiatives? Do they justify the new initiatives? Are they merely repackaging "old initiatives"?

(4) Resource Justification - Do they really justify their spending?

This apparent concern for accountability should motivate us to focus more of our audit efforts on Part III of the Estimates and on the performance information it contains.

Part III of the Estimates alone does not provide a full accounting of the matters of significance identified earlier -- namely financial regularity, legislative compliance and value for money. Financial regularity and legislative compliance are more specifically addressed in the financial statements and accompanying schedules in the Public Accounts. The Office is currently conducting a study of the government's financial statements in an effort to determine the essentials of the government's financial accountability and the manner in which it should be disclosed. This study will look at the fundamentals of financial accountability. This paper, therefore, will not discuss this issue further, but will pursue the subject of performance accounting as it relates to individual departments.

Auditing the Accounting for Accountability

A Perspective on our Responsibility to Parliament

In the private sector the "bottom line" says a lot about the quality of management practices. On the other hand, the Office in the past has taken the position that the quality of management practices <u>is</u> the "bottom line". In effect, we have said to Parliament that, with assurances about management practices, there is little need for information about results. We have not said this directly, but by

implication. Even today, our comprehensive audit chapters often focus on systems and procedures, to the exclusion of commentary on results, or even on accounting for results.

Does the Office owe any less to its ultimate client, the taxpayers, than public accounting firms do to a corporation's shareholders? In fact, do we not owe more?

A corporation's shareholders are not locked in and benefit in direct proportion to their investment. Taxpayers, on the other hand, have no choice but to pay their taxes and rarely receive direct benefits in proportion to the taxes they pay. They, of all people, should get a full accounting. But since they are locked in and have little or no say between elections, they get little or no information on what has been accomplished with their tax dollars.

The Office should ensure that taxpayers get the right information through their representatives in the House. The information should come from the Government and the OAG should assess it and attest to its completeness and reliability. In other words, the accountability of Government should be reflected in its accounting and subjected to appropriate audit.

Accounting for efficiency and effectiveness, while not simple, is marked by certain conventions. Economy issues, on the other hand, are not so marked. The "accounting" for economy might be through the work of the Office in examining key economy issues. The same can be said of financial regularity and legislative compliance issues. The "accounting" might occur through our audit of these areas and the findings we make, favourable or unfavourable.

Private sector auditors routinely assess the adequacy of disclosure and the fairness of the data. One can imagine the reaction of shareholders if they received only comments on management practices and were left on their own to sort out the meaningfulness of the financial statements. Yet at times we seem to expect Members of Parliament to accept enthusiastically our comments on

systems and processes, while they remain uninformed on whether value for money was achieved.

Where performance information does not exist, should the auditors go beyond simply pointing this out to the House of Commons? Should they attempt to generate the information themselves as the U.S. General Accounting Office does? The answer is yes as far as the economy, efficiency and day to day operational effectiveness are concerned. As for program effectiveness, or impact on the public, the answer is probably no, at least for the foreseeable future. If effectiveness evaluation is not forthcoming from the Government within a reasonable time, this position would merit re-examination.

The Accountability Audit

Accountability auditing has essentially two dimensions. The first concerns attesting to performance reports and the second to levels of performance.

Auditing Performance Reports. As already stated, Part III of the Estimates requires the inclusion of a variety of performance data designed to demonstrate, among other things, that value for money has been achieved.

Our audit responsibilities should include expressing our opinion on the extent to which:

- the information by its nature captures the essentials of value for money; and
- the information is reliable.

This is not unlike a financial attest audit, except that there are no generally accepted accounting practices. This should cause us to develop suitable approaches to discharging our responsibilities rather than turning away from them.

It will be necessary to understand fully what departmental programs are trying to accomplish and what performance indicators would best reflect that

accomplishment. Where they are not being used or have not been developed, we should point this out in our Report and suggest indicators for consideration. Where suitable indicators are used, we will have to test the data for reliability.

There remains the question of whether the performance data in the Part IIIs should be audited annually or only in the context of a comprehensive audit. The Accounts of Canada are audited annually, but that is mandatory. However, the Office considers levels of materiality when selecting departmental transactions for review.

The issue of materiality is equally relevant to an audit of the performance data in Part III of the Estimates. Auditing the performance claims of larger departments, therefore, should probably be done annually. Since these departments seem to have ongoing comprehensive audits, the work could be addressed without special effort. Smaller departments would have their performance data audited as part of the periodic comprehensive audit.

Auditing Levels of Performance

An audit opinion on performance reports would be useful to Parliament. Equally useful, and perhaps more so, would be some sort of opinion on the level of performance. This opinion would not necessarily be given directly. We could seek out major opportunities where a department could improve its performance in value-for-money terms or advise Parliament that such opportunities do not exist.

This part of the audit would be conducted in a way similar to our comprehensive audits. However, we would have to place a clearer focus on "results" when we examine program operations and systems. This part of the audit would concentrate on the aspects of a program that most influence results. The identification of major opportunities to improve performance and performance reporting would constitute the majority of "matters of significance" reported to Parliament.

The results-related categories on which we would focus would be: financial regularity, legislative compliance, economy, efficiency and effectiveness. These terms are not new, but it is worth reviewing what they mean and how auditors should approach them.

Financial regularity. The work of the Office in this area has generally been in the context of expressing an opinion on the accounts of Canada. It is rare that comprehensive audit chapters have touched on matters of financial regularity.

Comprehensive audits should include a determination of any key financial management and control issues, in addition to purely accounting ones. Programs marked by large grants, contributions or other transfers certainly should have the financial control over expenditures examined. Examples of such programs are found in DRIE, Employment and Immigration, and National Health and Welfare.

However, there is the basic question of what we mean by "financial management and control" in the public sector. It is not the same as in the private sector, but exactly how is it different? By what criteria should it be audited in any particular department? Did the Office's earlier studies of Financial Management and Control (FMCS) address the right issues? If so, should they continue to be addressed in each department, where significant? In any event, one important criterion might be the impact of financial management and control on value for money.

The Office has recently decided to undertake a Financial Accountability and Control Evaluation Study (FACES) to report in 1987. One output of that study will be methodology for addressing these issues in comprehensive audits. The methodology will be piloted in the spring of 1985.

Legislative compliance. As with financial regularity, legislative compliance has generally been approached within the context of Public Accounts Audit. Our findings in the area make up a large part of the Audit Notes chapter. These findings generally arise from our financial transactions audit leading to our

opinion on the accounts of Canada. They are rarely the result of comprehensive audits, since authorities issues are seldom included in the audit scope.

Legislative compliance goes beyond spending money only for "purposes for which it was appropriated by Parliament." Some departments' principal role is to enforce very specific legislation. Examples of these include National Revenue-Taxation and Customs and Excise, Employment and Immigration, RCMP and Veterans' Affairs. Other departments have a significant portion of their activities governed by specific legislation containing detailed provisions requiring compliance. Examples include Energy, Mines and Resources' Petroleum Incentives Administration and Health and Welfare's Income Security Programs.
All departments have enabling legislation, some specifically directive, and many permitting the development of regulations requiring compliance on the part of the department and those whom the regulations concern.

Comprehensive auditors should identify which legal authorities apply uniquely to the department under audit and which of these are significant in terms of their impact on value for money. Audit programs should be developed to address the related compliance issue. As for less significant compliance issues, these should be left to the internal auditor; most Treasury Board directives and guidelines would fall in this category.

Value for Money. Value-for-money is composed of economy, efficiency and effectiveness. Although the Office has been conducting value-for-money auditing since 1977, it still seems to be that authorities issues, and not value-for-money findings, capture Parliament's attention. I would contend, though, that this is because we present authorities issues in a case fashion. MPs can relate better to cases than they can to abstract speculation about the impact on VFM of various systems deficiencies. If we are to get Parliament more involved in addressing value-for-money issues, then we have to include cases in the comprehensive audit chapters.

It is worth reviewing what the terms economy, efficiency and effectiveness mean within the context of value-for-money auditing.

Economy

- Due regard for economy involves getting the right resource, in the right amount, at the right time, in the right place, at the right cost.

- The auditor should determine the principal resources used by the entity, what is meant by the right resource, amount, time, place and cost, what the risks are of any of those not being "right", and what the consequences would be.

- Information is often considered a resource, and an important one. Certainly there are economy issues associated with information, but these generally relate to the primary resources -- things (hardware) and people (liveware and software). The following addresses the economy issues associated with the primary resources -- people, things and money.

- **People**
  - They can be hired ready to start to work just with orientation. In other words, they are already the <u>right</u> resource; e.g., professionals such as accountants and lawyers, and most administrative support staff.

  - They can be hired with a major training requirement to make them the <u>right</u> resource, e.g., air traffic controllers, RCMP, military, auditors, postal workers. In such cases, the training they are given to make them the <u>right</u> resources becomes a major part of the economy issue.

  - They can be rented, ready to go to work. The rental option is preferred when it is not cost-beneficial to have permanent staff year round, either because of cyclical demand or because the special skills involved could not be used throughout the period.

- A cost analysis to determine whether to hire, hire and train, or rent, should precede the resourcing decision.

- **Things**
  - Things are capital equipment, buildings and accommodation in general, vehicles of all sorts, EDP hardware, various consumables.

  - Whether "things" are a key resource depends on the government program in question and the importance of the "thing" to the performance of the program. For example, general purpose office accommodation is rarely critical to the success of a program, and therefore, for the occupant department, it would not be considered a major economy issue. However, for DPW, the property manager, it would be an important economy issue, because DPW is charged with acquiring suitable accommodation at least cost.

    For departments with special purpose accommodation needs and that have some say in the construction specification, the economy issue might relate to both the department and DPW or, in some cases, to the department alone, such as DND. Other agencies with special accommodation needs would be the Correctional Service, Canada Post Corporation, and those operating scientific research establishments.

  - The auditor must establish the "things" that are key to program performance and determine what economy issues are associated with them.

- **Money**

  - Money is used to hire people and to buy things; i.e., it is a medium of exchange. When it is used to accomplish a program

objective on its own, it becomes a resource, along-side people and things. It becomes a program instrument. For example, in welfare allowance programs, money is the instrument for achieving some anti-poverty goal. Similarly, through direct or tax expenditures, scientific research goals could be pursued.

- In such cases, the question of the right amount of money, at the right time and in the right place, is more one of effectiveness than economy. Inadequacies of any of these would impact directly on the effectiveness of the program. The Review of Cash Management chapter in our 1984 annual Report identified a number of economy issues which apply to departments at large.

Efficiency

- Efficiency means maximizing outputs for any set of inputs or producing a given level of output at least cost.

- Program managers throughout government should be concerned about maximizing efficiency. The auditor should look for evidence of that concern. Where feasible, efficiency should be measured by the department. Feasibility relates to the ease of measurement, particularly of outputs, and the significance of efficiency or its potential for improvement. Even where the measurement of efficiency is impractical, there should be efforts to improve overall efficiency. The department should be constantly on the alert for better ways of delivering its products, even if the improvement in efficiency can be only approximated. First of all, the ongoing need for the service or product should be determined. Eliminating useless services or products permits funds to be used productively elsewhere.

- The measurement and management of efficiency is most straightforward where a production setting is characteristic of the activity in question, e.g., processing claims, doing inspections, paper

pushing in general. The auditor can easily identify the efficiency issues in such cases. A related issue might be the extent to which internal efficiency is improved by increasing the paper burden on the public. Such trade-offs can often occur.

- There are other cases where efficiency is just as important, perhaps even more important, but not so easily measured or managed. In these cases the efficiency issue generally relates to choosing the right method of producing and delivering a particular service.

- Assessing whether the most efficient methods are being used is often neither simple nor conclusive. If possible, comparisons can be made with similar organizations. That might indicate relative efficiency and opportunities to improve efficiency. No two organizations are exactly the same, so comparisons require careful interpretation to ensure they are valid.

- Labour efficiency attracts the most attention. Labour productivity is monitored on a national basis and international comparisons are made. The auditor must consider all factors of production, especially when automated clerical processes are on the increase. Program managers should be attentive to opportunities to automate and otherwise streamline their operations. Due regard for efficiency demands this.

- The literature on efficiency measurement and management is generally found under the heading "PRODUCTIVITY". Searches should be made for each major operation examined to see what precedents have been established, e.g., postal service, vehicle maintenance, clerical processing.

- The distinction between economy and efficiency is often blurred. Over-priced resources have an impact on the unit cost of output. Movements in performance indicators, such as unit costs, are often

seen as changes in efficiency and require careful analysis to determine their cause.

Effectiveness

- Effectiveness entails producing the intended results at least cost while minimizing undesirable side effects.oThe overriding concern should be whether government programs are effective and whether Parliament has been so informed.

- Auditors must understand the various objectives of the program or activity under audit, the means by which they are achieved and the indicators of success in achieving them. They should also understand how one would measure the success of the program/activity. Consideration must be given to the environment in which the program operates and the exact relationship it has with the public.

- Side effects are also an important issue, as is the interaction of the program with other programs of the department, of the federal government, and of other governments, domestic or foreign.

- Where a program that has an impact on the public is under audit, the auditor is concerned principally with departmental procedures to measure and report effectiveness. Where the focus is on an operation or activity whose outputs are consumed internally, the auditor has the same concern. However, in that case, where departmental measures are not in place, the auditor should consider measuring directly the operation's effectiveness. For example, in the postal service the auditor might assess the effectiveness of the configuration of employee and machine in a particular location. In the Correctional Service, the auditor might determine whether the food service is meeting its goals in terms of nutrition and cost. The important point is that operational effectiveness can and should be assessed by the

auditor without fear of being criticized for appearing to overstep the Office mandate.

Summary

The Office is responsible not only for auditing value for money, but also for demonstrating it. In linking accountability, accounting and audit I have provided a framework that should help us accomplish that. The more specifically we can focus our audit efforts on the government's performance reporting and on the performance itself, the less likely we are to consume scarce audit resources in examining matters of little significance to the House of Commons.